REPORT TO THE SECRETARY OF THE TREASURY FROM THE TREASURY BORROWING ADVISORY COMMITTEE OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

February 4, 2009

Dear Mr. Secretary:

Since the Committee last convened in early November, the contraction in economic activity has deepened and broadened, while financial markets have remained under duress. The unprecedented volatility present in capital markets when the Committee last met has diminished somewhat but conditions still are exceptionally challenging. Policy efforts have begun to unlock credit for select high-quality borrowers. But the magnitude of wealth destruction, the still heightened cost of economy-wide capital and the impaired system of financial intermediation continue to cast a dark cloud over the economic outlook.

Monetary and fiscal policy action now being implemented will help to prevent an even more serious downturn than otherwise would be the case. Policymakers' efforts to restore the flow of credit to households and businesses, backstop critical financial intermediaries through capital injections and loan guarantees, and stimulate economic activity via lower interest rates, tax cuts and government spending are positives. Nonetheless, the necessary deleveraging of both the financial and household sector is considerable and has further to run.

Price pressures are receding rapidly. Headline inflation already has collapsed toward zero due in large part to the steep declines in commodity costs. More notably, core inflation also is cooling quickly amid the slump in demand and rising unemployment and remains close to the Federal Reserve's comfort range for this series. Moreover, the speed at which businesses are cutting headcount and reducing compensation is raising the risk of deflation. Given elevated debt levels, such an outcome would be extremely problematic for the financial sector and real economy.

Federal Reserve officials have dropped the funds rate to effectively zero and are focused on using the bank's balance sheet to help to restore the flow of private sector credit. Forthcoming implementation of the TALF program to restart the flow of credit in the asset-backed securities market is one example of the Fed's efforts, as is its ongoing purchases of agency and agency-backed mortgage debt. Additional asset purchases – including the buying of Treasury securities if the FOMC determines that such purchases would be "particularly effective in improving conditions in private credit markets" – also are possible.

Despite the latest steepening in the yield curve, the curve has flattened since the Committee convened in November. The spread between the two- and ten-year and two- and thirty-year Treasury yield, for instance, has narrowed by about 50bp and 25bp, respectively. The flatter curve, despite a lower funds rate, reflects investors' concerns about deflation. The recent steepening led by the rise in longer-dated yields, however, partly may be a by-product of the Treasury's outsized funding needs in 2009-2010.

Further substantive increases in Treasury yields may prove counterproductive to policy actions already underway.

Those outsized funding needs reflect the dismal outlook for economic growth and Congress and the Administration's efforts to bolster the economy through policy action. Tax receipts are declining at a brisk pace given the climb in unemployment, reduced wealth and slowing corporate profits. Receipts were down by nearly 10% in the first three months of the new fiscal year and the pace of decline appears to have accelerated in January. Individual nonwithheld tax receipts in the month plunged by almost 15% versus a year ago. Meanwhile, outlays are surging at a breakneck pace as automatic stabilizers (unemployment compensation, food stamps, etc.) kick in and the government puts in place programs to try and stabilize the financial sector.

The deterioration in the budget outlook, combined with expenditures associated with the TARP, potential FDIC guarantees, and expected additional stimulus spending have increased private forecasts for total funding needs of the U.S. government for fiscal year 2009 to approximately $2 trillion. This is likely to stress the existing auction schedule and consequently warrants tangible adjustments to that schedule.

Faced with an unprecedented increase in net borrowing needs, the Treasury in its first charge to the Committee sought our advice and recommendation on changes to the auction calendar for debt issuance.

In keeping with past practices, the Committee recommended that the Treasury address its needs by reviewing the size, frequency and then the elimination, or in this case addition of debt maturity issues.

Furthermore, the Committee also stressed the importance of maintaining focus on the overall average maturity of the debt to ensure that financing is distributed across the maturity spectrum.

Faced with such extraordinary financing needs, the Committee focused on the optimal potential size of each coupon issue, while not jeopardizing a successful auction process.

It was the Committee's recommendation that existing monthly 2-year and 3-year notes could be increased by $5 billion in size, to $45 billion and $35 billion, respectively.

Furthermore, the Committee recommends that monthly 5-year notes have the greatest room for expansion given their liquidity and focus and should be increased by as much as $10 billion per issue. This would bring the monthly issuance size to as much as $40 billion.

And lastly, the committee recommends that the Treasury increase the size of the newly issued quarterly 10-year notes by $5 billion and by $4 billion when re-opened the two months following the new issue. In other words, the sizes of the 10-year issuances would increase from $20 billion, $16 billion and $16 billion each quarter to $25 billion, $20 billion and $20 billion, respectively.

The Committee also reviewed the frequency of the relevant issues and reiterates its recommendation to Treasury to issue 30-year bonds monthly, following the pattern of 10-year issuance. In other words, to have a new 30-year bond auction each quarter in February, May, August and November followed by re-openings of that issue in the two months following. The Committee recommends that the Treasury size these auctions to $15 billion, $10 billion, and $10 billion, respectively.

Furthermore, the Committee recognized that the changes were not sufficient to meet its borrowing needs and that the Treasury must introduce new coupon issues to its calendar.

While the number of new issues discussed by market participants, and the Committee, were a 4-year, 7-year, 20-year, and super-long (50-year) maturity issue. Among these choices, the Committee believes that a 7-year issue would be best accepted by the marketplace.

Consequently, after much discussion, the committee recommends that the Treasury announce a new 7-year maturity issue monthly. The pattern and size of the issue is recommended to be $15 billion quarterly, with subsequent re-openings of $10 billion over the following two months.

A number of Committee members noted that despite the tremendous growth in proposed coupon issuance, the average maturity of Treasury debt will likely fall further and that additional changes will need to be discussed by market participants in coming months.

The average maturity of the debt has already fallen from a range of 60 to 70 months which existed from the mid 1980's until 2002 to a level of 48 months more recently.

One member of the Committee suggested that the Treasury consider setting a target or guideline for this measure. While few agreed with setting a hard target level, most concurred that the Treasury needs to be focused on distributing its issuance across the maturity spectrum and avoid letting the average maturity fall too low.

In its second charge to the Committee, the Treasury sought our input on factors that might affect the supply and demand for Treasury securities over the next couple of years.

One member presented a deck of charts and exhibits that were prepared prior to the meeting and are attached.

There is near consensus that Treasury's funding needs during the next two years will be the largest in the post-war era in dollar terms, and likely also as a percent of GDP. To date, stepped up issuance has been digested well, owing in part to the rock bottom level of the risk free overnight rate, deflationary concerns, and outsized demand among global investors for safe and liquid financial instruments amid the contraction in global economic activity.

But the ramp up in debt issuance remains in its early stages. As the US government and also foreign governments continue their efforts to stabilize their respective economies, the supply of government and quasi-government paper will grow rapidly. The sheer magnitude of paper set to be issued raises the possibility that investors at some point will demand a concession of some sort, lifting yields in parts of the term structure beyond those justified by macro fundamentals. As a country with a current account deficit and a majority of Treasury debt held abroad, the US is more at risk of such a development than a country such as Japan where the government bond market is primarily domestically held.

To a certain extent, the supply and demand for Treasury securities in the period ahead are intertwined. The more pronounced and longer the recession, the larger the budget deficit, (both for economic and policy reasons) and in turn the greater the supply of debt. At the same time, however, demand for Treasurys would remain elevated, as investors would be wary of fleeing the safety of government securities for higher yielding but riskier asset classes.

The net supply of Treasurys in 2009 and 2010 combined seems likely to total more than $3 trillion and could climb as high as $4 trillion. The Congressional Budget Office (CBO) estimates the 2009 Federal budget deficit to be $1.2 trillion. The consensus of private sector analysts is similar to that figure. Yet, neither the CBO estimate nor the private consensus reflect fully the funding needs associated with the Obama Administration's fiscal stimulus plans, the implementation of TARP (or another TARP-like program), or the rumored creation of a bad/aggregator bank to help deal with the underperforming assets weighing down financial institutions. Some of the funding of these government programs will spill over into 2010, a year in which the "core" budget position also will be weak according to mainstream expectations for economic performance.

Actual and potential funding needs for financial sector stabilization programs already announced are considerable. Guarantees made on select assets of systemically critical financial institutions could require Treasury to raise hundreds of billions of dollars in the event that these assets continue to deteriorate. Similarly, guarantees made by the FDIC on select bank-issued debt could catapult government borrowing needs further should the issuing bank(s) default on its FDIC-insured paper. Any additional guarantees on future losses to assets held by financial institutions would further increase net borrowing needs by Treasury. The size of any such borrowing would hinge on the type and size of assets backstopped.

The expansion in quasi-government paper contributes to the risk of market saturation. Banks have issued nearly $150 billion in FDIC-backed paper since the programs introduction. Spreads on this paper have been narrowing over time with the latest deal, paper offered by Citi, pricing just 30 basis points over Libor. Real money investors have purchased the bulk of this paper in an attempt to pick up yield over Treasurys while not taking on additional credit risk. In some respects, this paper has replaced GSE debt as the instrument of choice for real money investors looking for modestly higher yielding, quasi-government debt.

Surging sovereign debt (and sovereign-insured private sector debt under programs instituted by some European governments) outside the United States also could compete with Treasury securities but this seems a modest risk at this point. The dollar remains the world's reserve currency and in periods of uncertainty and volatility typically enjoys a safe-haven bid. Indeed, the demand for dollar – including US Treasury debt – has been solid in recent months even though US policymakers have announced their intentions to expand fiscal and monetary policy. Moreover, the ratio of public sector debt in the US – even with the pending surge – will remain below that of many other developed countries, as the ratio will be rising from a relatively low base.

Nonetheless, international developments do pose some risk to the Treasury market, especially as the increase in supply accelerates further. Foreign investors currently hold nearly 55% of the marketable Treasury debt outstanding – a percentage that is only modestly higher than some other G10 economies – and a percentage that has been trending higher since early this decade. For instance, foreigners held about one-third of Treasury debt outstanding in 2000. Japan, China, and the United Kingdom are the three largest holders. Yet, the UK's elevated position reflects London's status as a global financial center and the large concentration of hedge funds in London, and is less relevant for debt management issues than Japan and China.

Japan and China both maintain outsized official holdings of Treasurys. The Japanese Ministry of Finance is not typically a net seller of dollars for anything beyond very minor portfolio rebalancing. In the current environment, Japanese officials may be more inclined to buy dollars (sell yen) in an effort to stem upward pressure on the yen, thereby halting Japan's terms of trade deterioration. Of note, however, the Ministry of Finance has not intervened recently.

China, on the other hand, could slow its accumulation of dollar-denominated debt. Such a trend already has begun to develop with respect to its accumulation of overall dollar assets as the flow of private capital into China has cooled alongside the global downturn, alleviating the need to offset capital inflows.

Emerging economies that have been accumulating dollars in recent years amid growing trade surpluses and the commodity price boom should have a reduced demand for dollars in the period ahead. Yet, foreign exchange reserves in countries such as Brazil, Mexico, Korea and so forth remain sizeable. These funds likely will diminish due to an unwinding of the forces that facilitated their rapid accumulation, and the possibility that policymakers in these countries will tap reserves for domestic initiatives. The net result will be less demand from the emerging world for dollar assets.

And finally, a larger primary dealer community would help to reduce on the margin the possibility of an undersubscribed auction(s). There currently are just 17 primary dealers, down from 30 a decade ago. Government bond trading desks at the dealers also are not immune from sector-wide capital/balance sheet issues and desks at many dealers are being encouraged to minimize risk.

In the final section of the charge, the committee considered the composition of marketable financing for the January-March Quarter to refund the $36.3 billion of privately held notes and bonds maturing February 15, 2009 the Committee recommends a $35bn 3-year note due February 15, 2012, a $25 billion 10-year note due February 15, 2019 and a $15 billion 30-year bond due February 15, 2039.

For the remainder of the quarter, the Committee recommends a $45 billion 2-year note in February and March, a $35 billion 3 year note in March, a $40 billion 5-year note in February and March, and a $20 billion re-opening of the 10-year note and $10 billion re-opening of the 30-year bond in March.

For the April-June quarter, the Committee recommended financing as found in the attached table. Relevant figures included three 2-year, 3-year and 5-year note issuances monthly, 10-year note and 30-year bond re-openings in April, followed by a 10-year note and a 30-year bonds in May followed by a re-opening of each in June, as well as a 10-year Tips note in April, and a 20-year TIPS re-opening later that same month.

Rick Rieder
Vice Chairman

Respectfully Submitted

Keith T. Anderson
Chairman